This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 04 PRETORIA 002161

SIPDIS

SENSITIVE

E.O. 12958: N/A
TAGS: EINV ECON EFIN ETRD SF
SUBJECT: SOUTH AFRICA: PUBLIC SECTOR INVESTMENT, PART II OF II

REF: A. PRETORIA 01998
¶B. 2004 PRETORIA 03113
¶C. CAPE TOWN 00114

(U) This cable is Sensitive But Unclassified. Not for Internet distribution.

¶1. (U) Summary. Faced with the dilemma of having so much capability vested in often-troubled SOEs and the slow decline of the nation's economic infrastructure, President Mbeki has set a new strategic course. The central element is to raise the level of public investment to improve the nation's infrastructure and achieve faster economic growth. In particular, Mbeki wants state owned enterprises (SOEs, i.e., public corporations with the state as the sole shareholder) and public-private partnerships at all levels of government to lead the way. Two giant SOEs, Eskom and Transnet, will be responsible for about half of R267 billion ($45 billion) in planned public sector investment over the next five years. The strategy represents a marked departure from the past, and effectively puts the government's privatization program of major SOEs on hold. The Department of Public Enterprises, which represents the government's shareholder interest in large SOEs, and the National Treasury, which must approve all PPP projects (ref A), will have to play leading and sometimes intersecting roles. End Summary.

Expanding the Role of the Public Sector

¶2. (U) South Africa has embarked on a public sector investment campaign driven by state owned enterprises (SOEs) and public-private partnerships (PPPs) to upgrade the nation's infrastructure and drive economic growth. In his February 2005 State of the Nation address, President Mbeki made it clear that SOEs and PPPs would lead public sector investment, especially to improve the nation's aging infrastructure, attract greater foreign investment, and to finally propel South Africa into a period of high, employment generating growth. In October 2004, Finance Minister Trevor Manuel announced plans to spend R267 billion ($45 billion) on public sector investment over the next five years. The government also wants public sector investment to create new opportunities for "Black Economic Empowerment" (BEE) companies.

¶3. (U) The change in policy has been accompanied by a fair amount of introspection. In an article entitled "A Failed Consensus" published in the New Agenda economic journal and the Financial Mail (May 27, 2005), Manuel questions the relevance of the Washington Consensus to African countries. "One of the most important drawbacks of the Washington Consensus" he writes, "was that, though it provide a good mixture of reforms to both stabilize the economy and encourage private sector activity, it did little to help resolve structural and institutional constraints on growth." He later concludes, "most African states need to expand, not contract, their public sector and dramatically improve (their) efficiency in delivering quality public services."

The Problem is Now the Solution

¶4. (U) Mbeki's new strategy represents a marked departure from the 1990s, effectively putting privatization on hold and breathing new life into large, monopolistic SOEs. South Africa's SOEs were originally formed to pursue the industrial policies of an economically isolated apartheid regime. In the mid 1990s, an ANC-led government embraced privatization as a way of dislodging SOE control of the economy, attracting foreign direct investment, driving economic growth, and ultimately merging the white and black economies. Government began unloading state assets and preparing parastatals for eventual privatization by converting them into public corporations and establishing industry regulators. While plans to restructure various industry sectors were drawn, most stalled for political, bureaucratic, and sometimes market reasons.

¶5. (U) Slow implementation gave SOEs the opportunity to prove to government that they could serve new political purposes -- such as rolling out ambitious social service programs to deliver electricity, water, transportation, and telephone services to the poor. Left-of-center politicians agreed,

pushing for an expanded role for SOEs to redress the inequities of the past. The problem was that many government social service programs were essentially unprofitable, and came sometimes at the expense of maintaining or investing in new infrastructure. The sad fact has been that, since 1994, SOEs have consumed far more fixed investment than they have contributed to the South African economy. This partly explains the serious bottlenecks in electricity supply and transportation services today. Now, the government's plan is to use the balance sheets and market dominance of these SOEs to invest in large infrastructure projects to overcome these bottlenecks and entice private sector investment through an assortment of PPPs.

Turning Frogs into Princes

¶6. (U) Faced with the dilemma of having so much capability vested in often-troubled SOEs and the slow decline of the nation's economic infrastructure, President Mbeki set a new strategic course for his second term. Essentially, he wants to turn SOE "frogs" into investment leading "princes." The "edge of the spear" may have been the late 2003 appointment of National Treasury Director General Maria Ramos as CEO of Transnet (the SOE parent of the national railroad, port, airline, and pipeline companies). Her instructions were to revitalize the transport sector, even if it means massive reorganization. Another key appointment was the reassignment of Minister of Trade and Industry Alec Erwin, the architect of Mbeki's public sector investment strategy, to Public Enterprises soon after the 2004 elections. His instructions were to press large SOEs into undertaking major investment programs, thus morphing them into drivers of economic efficiency and growth.

¶7. (U) Erwin has a lot of material to work with in the seven SOEs that he supervises. They include Eskom (electric utility), Transnet (transportation), Denel (defense), Alexkor (diamond mining), SAFCOL (forestry), Arivia.kom (information technology), and Aventura (vacation resorts -- in the process of being sold to a BEE company). Together, these SOEs employ 136,000 people, procure R13 billion ($2.2 billion) annually in goods and services, own combined assets of R176 billion ($29 billion), and generate R84 billion ($14 billion) in annual revenue, roughly equal to 6% of South Africa's GDP.

¶8. (U) Since his arrival at the Department of Public Enterprises (DPE), Erwin has thrown himself into overhauling the seven large SOEs that report to him, as well as re-engineering DPE itself (ref B). On April 15, during his budget presentation to Parliament, Erwin dismissed DPE Director General Eugene Mokeyane and Denel (defense SOE) CEO Victor Moche. He also declared that from now on SOEs would focus on their core businesses and sell off non-core assets. In fact, Denel, Eskom (electric utility SOE), and Transnet plan to sell assets totaling R8.6 billion ($1.4 billion). In addition, Denel's focus, in expectation of a large Airbus offset contract, will shift to aerospace instead of conventional arms. The other, smaller SOEs are still subject to sale.

¶9. (U) Erwin also wasted little time in making major changes at DPE, which he has already reorganized into four streamlined divisions: corporate finance and transactions, corporate structure and strategy, governance and policy, and analysis and risk management. In addition, Erwin has launched a major recruiting effort to find the skills his department needs to implement Mbeki's strategy, and to grow his staff well beyond its current 150 employees.

¶10. (U) Similarly, Ramos has wasted little time in making major changes at Transnet, including cleaning house of unwanted executives and reorganizing the state enterprise. Transnet's companies include Spoornet (railroad), National Ports Authority (port ownership), South African Port Operations (port operations), South African Airways (airline), and Petronet (oil and gas pipelines). In June 2004, Ramos replaced Transnet's Treasurer with a former General Manager from the National Ports Authority. In August 2004, she engineered the replacement of all members of the Transnet and South African Airways Board of Directors. In January 2005, she replaced Spoornet's CEO. Nicknamed "South Africa's Iron Lady," Ramos has earned a reputation for "no-nonsense" as she pulls out the stops to turn around her unwieldy state enterprise.

¶11. (U) Ramos quickly unfurled a four-part strategy to turn around Transnet that can be encapsulated as follows: (1) focus on core businesses; (2) restructure Transnet debt; (3) improve corporate governance; and (4) invest in human capital. In an effort to streamline a top heavy parent corporation, Ramos is in the midst of slashing Transnet staff from 700 to around 50. For focus on core businesses, Ramos plans to sell 14 non-core assets within the next 24 months, including Transnet's lucrative 26% stake in the Cape Town's Victoria and Albert Waterfront (ref C). Ramos will also cut

scandal-ridden South African Airways loose, converting it into its own state enterprise that will report directly to Erwin at DPE.

Spotlight on Eskom and Transnet

¶12. (U) Under the government's public sector investment program, two giant SOEs, Eskom and Transnet, will assume responsibility for about half of all planned investment, or R136 billion ($23 billion), over a five year period. Of considerable note is that Eskom and Transnet will not/not receive any budget support from government. They will have only their own cash flows, joint venture partners, and debt markets on which to draw.

¶13. (U) Eskom, one of the top ten electric utilities in the world in terms of generating capacity, is slated to spend R95 billion ($16 billion) to meet South Africa's growing demand for power over the next five years. The company plans to spend half of this amount, R48 billion ($8 billion), adding to its current capacity of 35,000 Megawatts (MW). This includes investing R12 billion ($2 billion) to bring back on line its Camden, Grootvlei, and Komati coal fired power plants, with a combined capacity of 3000 MW. In addition, Eskom will partner with the private sector to build two new 1000 MW power plants by 2009, together worth R23 billion ($3.8 billion). These investments should raise Eskom's overall generating capacity to more than 40,000 MW within five years.

¶14. (U) Meanwhile, Transnet is poised to invest R41 billion ($7 billion) in rail, port, and pipeline projects in an effort to create a seamless inter-modal freight transport service for the nation. Ramos recently told an investment conference that she was focused first on improving the nation's railways, as industry had constantly criticized Spoornet for poor quality service, inefficiency, and high prices. Her plan to restructure Spoornet includes investing R14 billion ($2.3 billion) on upgrading locomotives and improving the railways. In particular, the OREX line from the Sishen iron mine to Saldanha Bay will be upgraded to carry an additional 10-15 million metric tons of iron ore per year for export. Similarly, the Coallink line to Richards Bay will be upgraded to carry an additional 10 million metric tons of coal for export. Transnet will spend R7 billion ($1.2 billion) to redesign the ports of Durban, Cape Town, and Ngqura (Coega). Transnet will also spend R3 billion ($500 million) to build another multipurpose pipeline from Gauteng to Durban.

¶15. (U) As Ramos explained to the investment conference, Transnet must undertake such an ambitious plan to recover from its failure to invest in infrastructure over the past 30 years. Though she claimed that the private sector was "knocking on her door" at all hours to propose PPP projects, Ramos cautioned investors that Transnet would still take its time to evaluate proposals and to sequence rail, pipeline, and port projects in a logical manner.

Who's in Charge?

¶16. (SBU) Since much SOE investment should take the form of a public-private partnership (PPP), SOE investment plans would appear necessarily to intersect with the National Treasury's PPP program, begging the question: "Which department will lead?" According to National Treasury, the PPP Unit must approve all PPP project feasibility studies, requests for proposal, contracts, "value for money" reports, and management plans -- including those involving the SOEs (ref A). Therefore, National Treasury will lead. According to DPE, however, SOEs are not legally bound to obtain Treasury approval before investing. Therefore, DPE will lead when it comes to Eskom and Transnet investment.

¶17. (SBU) The PPP Unit official that we spoke to admitted that the government was entering uncharted territory, but pointed out that the Public Finance Management Act 1 of 1999 required Treasury to monitor the progress of all PPPs. He believed that all SOEs would likely have to obtain the Finance Minister's blessing before proceeding with PPPs, even though the investments did not draw directly from public coffers. However, it was not clear to him whether the National Treasury would scrutinize the implementation of all SOE PPPs. He speculated that maybe the DPE and/or the Auditor General (who reports to Parliament) would perform this function. He added that Treasury and DPE were not alone in administering the government's public sector investment strategy. Coordination was important. Other departments, such as the Department of Transportation and the Department of Minerals and Energy, would continue to play important roles as regulators and policy makers who supervised industry activity and devised sector development strategies.

Comment

¶18. (SBU) Mbeki has made it clear that he intends to use public sector investment to overcome growing deficiencies in national infrastructure and kick start faster economic growth for the country. To accomplish these goals, he has enlisted the support of all government agencies -- national, provincial, and municipal. He has clearly given marching orders to National Treasury and DPE, and expects them to lead. How these two departments relate to one another and how they coordinate with other government entities, many of which are classified by National Treasury as "under performing," may define the success of Mbeki's strategy, if not his second term. Beyond that, each department has its own implementation challenges. Will the PPP Unit at National Treasury be overwhelmed with projects just as the large SOEs role out their major PPPs? Can DPE turn around failing SOEs fast enough so that they can successfully perform the investment roles that have been identified for them? Mbeki is counting on DPE and National Treasury leadership to achieve high economic growth, reduce unemployment, and set the country on a solid economic footing for the next ten years. For this tender democracy with over 40% unemployment (broadly measured), the political stakes are considerable.

HARTLEY